

**P. PROMOTION OF FINE ARTS AND THE PERFORMING ARTS
ANALYSIS OF THE GOLDSBORO ART LEAGUE AND
PLUMSTEAD THEATRE SOCIETY CASES,
AND UBIT CONSIDERATIONS**

1. Introduction

Commerciality and exempt activity intersect in the area of promotion of art and theater. This area presents difficult questions for the Service, and at the present time the position of the Service and the Courts is unsettled. The reason for such confusion is apparent. It is possible to walk down the street of a major city, enter a proprietary art gallery and purchase works created by professional artists. In the same city, art museums and art appreciation leagues may sell original art works. In addition it is possible to purchase a ticket to see a play produced by a commercial enterprise looking for a profit, utilizing professional actors and production crews. Invariably that city sponsors one or more nonprofit community theaters which utilize the talents of amateurs and professionals in furtherance of dramatic arts. These examples are representative of easy cases. The proprietary gallery and the commercial producer of the play would not qualify for exemption under IRC 501(c)(3), while the art museum, art appreciation league and community theater would likely be exempt. However, the gradations of pertinent facts relating to such undertakings may be great. The only real certainty is that no two organizations are exactly the same. What would be the result if the art appreciation league sold art works created by professional artists as a primary activity? What if the nonprofit theater group decided to produce an ostensibly "commercial" theatrical event such as "First Monday in October?" These are not hypothetical questions, but real situations. Before we attempt to answer them, let us review precedent in the area.

2. Background

A. Performing Arts

It has long been the position of the Service that "cultural" type organizations qualify for recognition of exemption under IRC 501(c)(3). S.M. 1176, C.B. 1, 147 (1919), holds that an association organized and operated exclusively for the purpose of giving musical concerts of an educational character is exempt. Similarly, I.T. 1475, C.B. 1-2, 184 (1922), holds that a corporation organized to maintain a band for the purpose of giving free public concerts and to promote musical art is exempt as an educational organization. Example (4) of Reg.

1.501(c)(3)-1(d)(3)(ii) provides that museums, zoos, planetariums, symphony orchestras, and other similar organizations are examples of educational organizations. Building on the regulations example, Rev. Rul. 64-175, 1964-1 (Part 1) C.B. 185, holds that an organization whose main activity is producing plays and making classic plays of the theater available in cities and colleges throughout the United States by means of a permanent touring repertory theater company of the highest professional standards, qualifies for exemption under IRC 501(c)(3). Similarly, in Rev. Rul. 64-174, 1964-1 (Part 1) C.B. 183, an organization that assisted local communities in establishing their own repertory theaters was held to be exempt under IRC 501(c)(3). Also, Rev. Rul. 73-45, 1973-1 C.B. 220, holds that an organization formed to develop a community appreciation for drama and musical arts by sponsoring professional presentations such as plays, musicals and concerts qualified for exemption under IRC 501(c)(3). Promotion of jazz festivals and concerts was held to be educational in Rev. Rul. 65-271, 1965-2 C.B. 161. Educating individuals in group harmony singing was also deemed an exempt activity in Rev. Rul. 66-46, 1966-1 C.B. 133. An organization that conducted weekly workshops, sponsored public concerts, and secured paid engagements for young musicians and singers interested in acquiring concert experience was held to be exempt under IRC 501(c)(3) in Rev. Rul. 67-392, 1967-2 C.B. 191. Finally, in Rev. Rul. 79-369, 1979-2 C.B. 226, the Service held that an organization created to develop and promote an appreciation of contemporary symphonic and chamber music by recording and selling, primarily to educational institutions, new works of unrecognized composers as well as neglected works of more established composers, was exempt under IRC 501(c)(3).

In the area of unrelated trade or business, Reg. 1.513-1(d)(4)(iii), in discussing the dual use of assets and facilities, presents the following example:

a museum exempt under IRC 501(c)(3) has a theater auditorium which is specially designed and equipped for the showing of educational films in connection with its program of public education in the arts and sciences. The theater is a principal feature of the museum and is in continuous operation during the hours the museum is open to the public. If the organization were to operate the theater as an ordinary motion picture theater for public entertainment during the evening hours when the museum was closed, gross income from such operation would be gross income from conduct of unrelated trade or business.

In the private foundation area, private letter ruling 7937092, June 18, 1979, describes an organization whose principal goals are to promote and perpetuate the performing arts. The organization holds, as an investment, a taxable subsidiary that engages principally in the operation of theaters (including production and investment in productions) for the presentation of live theatrical performances. The subsidiary owns and operates legitimate theaters. The ruling holds that under the circumstances, the private foundation's investment in the subsidiary qualifies as a program related investment under Reg. 53.4944-3 and is a functionally related business under IRC 4942(j)(5). It should be noted that the position taken in 7937092 cannot be cited as precedent and is noted here only for illustrative purposes.

B. Arts and Crafts

An organization that exhibited the works of unknown artists to the public, but did not engage in selling art works, was held to qualify for exemption under IRC 501(c)(3) in Rev. Rul. 66-178, 1966-1 C.B. 138. Rev. Rul. 78-131, 1978-1 C.B. 157, holds that an organization that conducts an annual community art show in a non-commercial manner where artists may display and sell their works qualifies for exemption under IRC 501(c)(4). There, it was acknowledged that some private interest is served when artists profit from the sale of their work. However, it was determined that the organization was primarily engaged in promoting the common good and general welfare of the people of the community in view of the show's community orientation and participation. An organization that conducted annual festivals to provide unknown filmmakers with opportunities to display their films and sponsored symposia on filmmaking was held to qualify for exemption under IRC 501(c)(3) in Rev. Rul. 75-471, 1975-2 C.B. 207. On the other hand, Rev. Rul. 71-395, 1971-2 C.B. 228, holds that a cooperative art gallery formed and operated by a group of artists for the purpose of exhibiting and selling their works does not qualify for exemption under IRC 501(c)(3). Also, Rev. Rul. 76-152, 1976-1 C.B. 151, holds that an organization formed by art patrons to promote community understanding of modern art trends by selecting for exhibit, exhibiting and selling art works of local artists, and retaining a 10 percent commission on sales, (less than customary commercial charges), does not qualify for exemption under IRC 501(c)(3). The rationale for denying exemption to the organization described in Rev. Rul. 76-152 was that the organization was benefitting the private interests of the artists whose works are displayed for sale. This may seem to be quite clear with facts showing that artists are being charged less than fair market rates for services rendered. Rev. Rul. 80-106, 1980-1 C.B. 114, approved a situation involving an IRC 501(c)(3) organization operating a

thrift shop that sells consigned goods. There, all transactions between the consignors and the organization are at arms length; amounts received by the consignor are reasonable; and, any benefit to the consignors are incidental to the charitable purposes of the organization. The Rev. Rul. holds that the sale of items on consignment does not result in inurement of net earnings to the benefit of any private shareholder or individual, nor do the transactions serve a private rather than a public interest. The private interest accruing to a for-profit radio station was seen as fatal to exemption in Rev. Rul. 76-206, 1976-1 C.B. 154. There the organization attempted to generate community interest in the retention of classical music programs by a for-profit radio station. Benefit to the for-profit station was seen as more than incidental.

Two recent Tax Court decisions put all of our published precedent to the test. The two cases are Goldsboro Art League, Inc. v. Commissioner, 79 T.C. No. 28 (December 8, 1980) and Plumstead Theatre Society, Inc. v. Commissioner, 74 T.C. No. 97 (September 26, 1980). The final outcome of these two court cases may be quite significant in the area of exempt organizations promoting fine arts and performing arts.

3. Factual Background of Goldsboro and Plumstead

A. Goldsboro Art League

This organization was incorporated under the nonprofit corporation laws of a state. Its purposes are: to promote the appreciation of and participation in the visual arts; to promote and encourage the expression of the visual arts; to promote and encourage the expression of creativity through the creative arts; to promote education in the fine arts; and, to sponsor a creative arts center to provide a facility for instruction, creation and display of paintings, statuary and objects of creative art. The organization's art activities are centered in an area where there are no other art museums, galleries or similar facilities available. The organization operates an art center in conjunction with a local college. The center sponsors art classes in such areas as water colors, oil and acrylic painting, pottery, interior design, macrame, and weaving. 20 to 25 classes are offered quarterly for approximately 250 students. On its own, the art center offers courses for children in pottery, drawing, discovering art, puppetry, creative stitchery and painting. The center also sponsors workshops and art demonstrations, including one at a local fair each year. In conjunction with the college and a state art society, the center sponsors an educational film series. The center owns 52 pieces of art as a permanent collection which it displays in various public buildings throughout the county, including the

college, local hospital and governmental buildings, and the public library. Local scout troops, school groups, clubs, and other interested persons are given tours of the center, and hundreds of persons are involved in the center's activities each week. The center's director lectures on art at the local high school and speaks at elementary schools. The organization conducts art workshops for teachers and sponsors public exhibits of the art work of public school children. The organization also offers darkroom space to the local camera club, organizes bus tours to art museums in larger cities and sponsors tours to the two local state supported mental institutions.

In addition to all these charitable and educational activities, the organization operates two public galleries: an art market and an art gallery. All artworks in these galleries are selected by jury procedures to insure artistic quality and integrity. Both the art market and the art gallery are similar in that they both exhibit and sell artworks. However, the art market invites displays from numerous artists while the art gallery features one artist per month. The more daring works of the artist are shown. Various classes of membership in the organization are entitled to a 2 to 10 percent discount on the sales price of art works in the two galleries. Art works for sale include paintings, drawings, sculpture, etchings, serigraphs, lithographs, weavings, pottery, and mobiles. No written contract is entered into between the organization and the artists specifying the terms of the sale. The organization collects and turns over any sales proceeds to the artist less approximately 20 percent commission for estimated expenses. The following is financial data concerning the art sales:

	art gallery		art market	total revenues
1976	\$ 4,624	Gross	\$ 3,662	\$ 47,109
	\$ 1,005	Net	\$ 398	
	\$ 507	Profit	\$ 359	
1977	\$ 5,984	Gross	\$ 3,309	\$ 47,440
	\$ 1,147	Net	\$ 860	
	\$ 536	Profit	\$ 676	
1978	\$ 6,281	Gross	\$ 5,106	\$ 57,289
	\$ 1,204	Net	\$ 849	
	\$ 651	Profit	\$ 737	

Because the organization's activities were thought to be indistinguishable from commercial art gallery activities it was denied exemption under IRC 501(c)(3). Our final adverse ruling stated that the organization is not operated

exclusively for exempt purposes; that it is operated to further substantial commercial purposes; and, that it serves private rather than public interests. The organization sought declaratory judgment relief under IRC 7428.

B. Plumstead Theatre Society

This organization was incorporated under the nonprofit corporation laws of a state. Its purposes include: promoting and fostering understanding and public interest in the fields of theater, dance, music, motion pictures, and the arts; promoting and encouraging the creation and performance of work in those fields; organizing and conducting workshops; giving recognition in those fields to writers, performers and organizations; and, giving public performances in each of those fields.

Initial proposed activities of the organization included presenting professional dramatic theater productions of the classical nature; forming a workshop in the Los Angeles area for new American playwrights; and, establishing a fund to assist new and established playwrights in writing new plays for the organization to produce. The organization entered into an agreement with an exempt charitable organization for joint sponsorship of a season of three family oriented plays. The organization intended to present its productions in Pasadena, California and Washington, D.C., and in any other city where subscription prices and/or theater guarantees would help defray costs of production.

In 1977, the organization entered into an agreement with the Kennedy Center to co-produce the play "First Monday in October." Both the organization and the Kennedy Center were each to provide one-half of the capitalization required for the production and to share equally any profits or losses derived from the presentation of the play in Washington. The organization's president, Henry Fonda, starred in the play and agreed to accept a lesser salary than usual and to waive a royalty interest in gross receipts.

To obtain required funds for this production, the organization entered into a California limited partnership called the First Monday in October Company. The organization is the general partner, while two individuals and a for-profit corporation, are the limited partners. Under the partnership agreement, the limited partners were required to contribute \$100,000 as capital contributions toward production of the play. The partnership is to continue for 18 years after the close of the last first-class run of the play unless terminated sooner. The partnership contemplates that the play will be produced in Washington, on Broadway and

elsewhere. If productions other than in Washington are undertaken, additional capital may be required of the limited partners. Net profits or losses, computed yearly, are to be shared 36.5 percent to the organization and 63.5 percent to the limited partners. No distribution of profits is to be made before the limited partners have received a return of their total capital contribution.

The Service took the position that the activities were in furtherance of a substantial commercial purpose and, because it was operated for the private interests of the limited partners, exemption was denied under IRC 501(c)(3). The organization sought declaratory judgment relief under section 7428.

4. The Tax Court Decisions

A. Goldsboro Art League

The Tax Court disagreed with our denial of exemption and found that the purpose of the art gallery and art market is primarily to foster community awareness and appreciation of contemporary artists, and to provide a constant flow of art for students to study art and painting techniques. The Court noted the circumstances surrounding the operation of the art gallery and art market as illustrating that the organization intends to educate rather than to sell. The following factors were deemed important by the Court:

1. there are no other art museums or galleries in the area;
2. a jury selects those works that are displayed;
3. works are chosen not for salability but for their representation of modern trends;
4. an artist's more daring works are exhibited;
5. other activities are educational; and,
6. art sales were not conducted at a profit.

The Court believed that the sales activities were incidental to the organization's other activities and served the same overall objective of art education (emphasis added). The sales activities were seen as secondary and incidental to furthering an exempt purpose. The Court rejected the Service's

position that private individuals were benefitted by the sales activities. Rev. Rul. 71-395 and Rev. Rul. 76-152, noted in 2(B) above, were deemed inapposite and distinguishable, respectively. The Court also stated that the private benefit prohibited under IRC 501(c)(3) did not flow to the artists whose works were sold since the artists did not control the jury selecting the works. It was further stated that the proscription against private inurement to the benefit of any shareholder or individual does not apply to unrelated third parties.

B. Plumstead Theatre Society

The Tax Court disagreed with our denial of exemption and found that the organization is operated exclusively for exempt purposes; that co-producing the play "First Monday in October" was not indicative of a substantial commercial purpose; and, that no private interests were served. The Court viewed the organization's main focus as being the organizing of a regional theater in Pasadena, California. It saw the play as being in furtherance of fostering dramatic arts, one of the organization's purposes. The Court cited Broadway Theatre League of Lynchburg, Va. v. United States, 293 F. Supp. 346 (W.D. Va. 1968), which held that an organization that brought professional theater to a city on a non-profit basis qualified for exemption under IRC 501(c)(3). This conclusion was reached despite the organization's contracting with a booking agent to book theatrical productions in return for 15% of the organization's membership dues.

The Court presented a general discussion of the differences between commercial and nonprofit theaters. The following characteristics were attributed to commercial theaters:

1. commercial theaters are operated to make a profit;
2. they choose plays having the greatest mass audience appeal;
3. they run the plays as long as they can attract a crowd;
4. they set ticket prices to pay the total costs of production and to return a profit; and,
5. since their focus is perennially on the box office, they do not generally organize other activities to educate the public and they do not encourage and instruct relatively unknown playwrights and actors.

The following characteristics were attributed to tax-exempt organizations:

1. tax-exempt organizations are not operated to make a profit;
2. they fulfill their artistic and community obligations by focusing on the highest possible standards of performance by serving the community broadly; by developing new and original works; and by providing educational programs and opportunities for new talent;
3. they keep the great classics of the theater alive; they are willing to experiment with new forms of dramatic writing, acting and staging;
4. they present a number of plays over a season for a relatively short specified time period;
5. many present their performances in halls of limited capacity;
6. with tax-exempt organizations, for various reasons, box office receipts do not cover the cost of producing the plays.

The Court approved the partnership arrangement which it conclude was entered into at arms length, and was neither obtrusive nor indicative of private interests.

5. Current Service Positions

The Plumstead decision is being appealed with respect to the issue of private interests of investors. As of early October, reply briefs had been submitted, but it is uncertain when the appeals court opinion will be rendered. The Service is pursuing the partnership issue, since we view the formation of a partnership agreement between the organization and limited partners as having an adverse effect on the organization's tax-exempt status. The arrangements provided the limited partners with substantial financial benefits that are not merely incidental to accomplishment of the exempt organization's purposes, and are not the result of an arms length agreement. For a discussion of the effect on exemption of organizations engaged in profit making partnerships, see 1981 EO CPE Textbook, page 5 et seq.

No final decision has been made regarding Goldsboro. No circuit court appeal will be made because the time for appeal has passed. It is uncertain whether the Service will acquiesce or not acquiesce in the Goldsboro case. Similar cases should be forwarded to the National Office for consideration.

6. UBIT Considerations

The Goldsboro and Plumstead issues can arise as unrelated trade or business issues under IRC 511-513. For example, if the facts in Goldsboro did not involve problems of private benefit, would the sale of art constitute an unrelated trade or business? Recently a private letter ruling considered this issue. Private letter ruling 8032028, dated May 5, 1980, describes an organization, exempt under IRC 501(c)(3), whose main function is the operation of an art museum. The organization displays works of art that are available for rent or for sale. The ruling holds that the sales of original art works do not contribute importantly to the accomplishment of the organization's exempt purpose, which is to educate the public in art by displaying art works for public appreciation. Selling original art works detracts from the organization's purpose since sold works are removed from public display. Thus, art sales were held to be an unrelated trade or business under IRC 513.